



Flow of Funds Figures Show the Largest Drop in Household Borrowing in the Last 40 Years

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Federal Reserve Flow of Funds figures released on December 11 report a drop in borrowing that is steeper than our previous projections in April 2008. After slowing to 0.5 percent of GDP in the second quarter of 2008, the change in household debt outstanding in the third quarter was a negative 0.8 percent of GDP (Figure 1). Borrowing by nonfinancial business was still positive, although the change in this sector's outstanding debt slowed to 2.2 percent of GDP, down from 4.2 percent in the second quarter. As Figure 1 shows, the previous two recessions saw a marked fall-off in business borrowing—with minor consequences for households—while the current recession's drop in credit is having a greater effect on households' finances.

As expected, a steep drop in mortgage debt accounts for most of the decline in household borrowing: the change in household mortgages outstanding is a negative 1.8 percent of GDP. Consumer credit growth, on the other hand, has slowed, but it is still a positive 2.3 percent of GDP. Sharply lower household borrowing has brought about a reversal of the upward trend in household debt (Figure 2), which nevertheless remains very large relative to income. If households' consumption behavior has shifted toward bringing debt back to a more sustainable path, we can expect a further decline in borrowing in the coming quarters.

According to the Levy Institute's macro model, a fall in borrowing has an immediate effect—which in this case accounts for a large part of the 3 percent drop in private expenditure that occurred in the third quarter. But it will also have delayed effects in the following quarters. As a result, the continuing decline in real GDP and accompanying rise in unemployment may be substantial (Figure 3).

For further details on our latest projections, see Wynne Godley, Dimitri B. Papadimitriou, and Gennaro Zezza, *Prospects for the U.S. and the World: A Crisis That Conventional Remedies Cannot Resolve*, Levy Institute Strategic Analysis, December 2008.

Figure 1 Change in Debt Outstanding

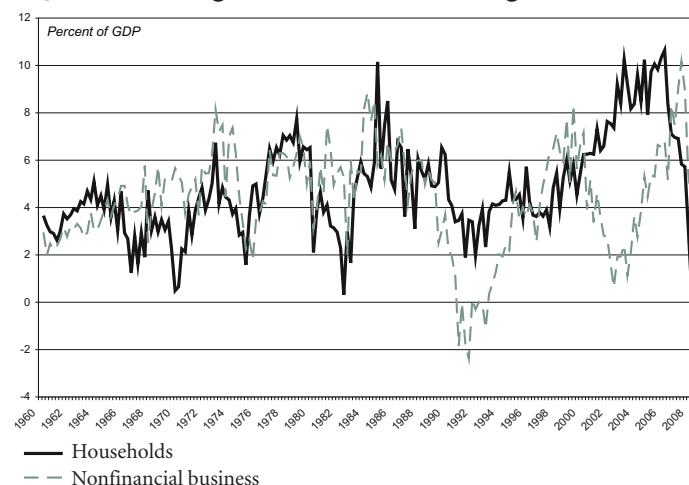


Figure 2 Household Debt Outstanding

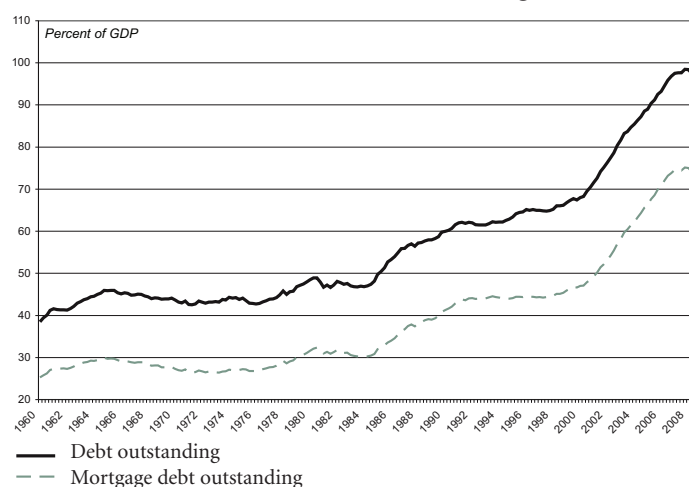


Figure 3 Unemployment Rate

